United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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P/S

75-7256

United States Court of Appeals
FOR THE SECOND CIRCUIT

S. William Green, Evelyn Green and Cynthia Colin, as Executors of the Estate of Louis A. Green, deceased, and Evelyn Green, individually, and as stockholders of Kirby Lumber Corporation, suing on behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

Plaintiffs-Appellants,

against

Santa Fe Industries, Inc., Santa Fe Natural Resources, Inc., Kirby Lumber Corporation, and Morgan Stanley & Co.,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York

BRIEF FOR PLAINTIFFS-APPELLANTS

Leventritt Lewittes & Bender
Attorneys for Plaintiffs-Appellants
405 Lexington Avenue
New York, N.Y. 10017
Tel. 986-4080

249 Press of Fremont Payne, Inc., 417 Canal St., N. Y.—966—6570

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NOTE: Emphasis supplied, unless otherwise noted.

BRIEF OF PLAINTIFFS-APPELLANTS

Preliminary Statement

Appeal from decision of Hon. Charles L. Brieant, Jr., District Judge; decision reported, 391 F.Supp. 849; reproduced in the Appendix (79A - 97A).

The Issues

1. Does not a short form merger, which freezes out the minority stockholders and wherein the fiduciary takes their stock worth at least $772 per share for $150 per share, without prior notice to or consent by them, violate SEC Rule 10b-5, particularly under Schoenbaum v. Firstbrook, 405 F2d 215 (C.A.2 en banc) and Popkin v. Bishop, 464 F2d 714 (C.A.2) ?

2. Since SEC Rule 10b-5 provides an independent basis of federal jurisdiction over Morgan Stanley & Co., defendant-appellee, did not the District Court also commit error in dismissing sua sponte the state claim against the diverse defendants-appellees, under Romero v. International Term. Operat. Co., 358 U.S. 354, 381, limiting the classic rule of Strawbridge v. Curtiss, 3 Cranch (U.S.) 267 ?

3. As to the state claim (under pendent and diversity jurisdiction): Is equitable relief available under

Delaware law under all the circumstances alleged including the unconscionable price paid by the fiduciary to its cestuis in this forced sale ?

4. Since the minority stockholders' corporation is the surviving corporation, does not a derivative action lie, as well as a class action ?

Statement of the Case

This is a derivative action in behalf of defendant Kirby Lumber Corporation, a Delaware corporation ("Kirby"), and a class action in behalf of its minority stockholders, including plaintiffs whose Kirby stock is alleged to be worth over $88,000 (79A; 76A). Kirby was controlled and dominated by defendant Santa Fe Industries, Inc. and the latter's wholly-owned subsidiary defendant Santa Fe Natural Resources, Inc. (jointly "Santa Fe") which owned 95% of Kirby's stock (80A-81A; 77A).

In order to freeze out the minority in a short-form merger, Santa Fe organized a dummy corporation which was then merged into Kirby without prior notice to the stockholders, and the minority were allotted $150 cash per share for stock worth at least $772 per share (81A; 73A-75A). Morgan Stanley & Co. ("Morgan") was joined as a defendant for aiding and abetting the fraudulent scheme (75A-76A).

The complaint alleged that this unconscionable self-deal violated Rule 10b-5 of the Securities and Exchange Commission ("SEC"), affording federal question jurisdiction (§27 of the Securities Exchange Act of 1934, 15 USC §78aa) and also pendent jurisdiction over a state claim for breach of fiduciary obligation (72A-73A; 76A).

The complaint was amended as of right to add a claim of diversity jurisdiction over the defendants other than Morgan (the latter like the plaintiffs being residents of New York, while the other defendants are Delaware corporations whose principal places of business are outside New York State) (72A-73A).

Defendants moved pursuant to Rules 12(b)(1) and (6), F.R. Civ. P. to dismiss for lack of subject matter jurisdiction and failure to state a claim upon which relief can be granted (8A). The District Court granted this motion (80A; 96A; 98A) and therefore did not reach the alternative motion under Rule 9(b) for alleged failure to state the fraud with sufficient particularity.

This appeal followed (99A). We submit that the decision below is erroneous as a matter of law.

Material Facts*

* The complaint having been dismissed on motion for failure to state a claim, "the factual allegations in the complaint must, of course, be taken as true" on this appeal. Vine v. Beneficial Finance Co., 374 F2d 627, 632-3 (C.A.2).

Plaintiffs claim violation of the Securities Exchange Act of 1934, §10(b) (15 USC §78j) and Rule 10b-5 (15 C.F.R. 240.10b-5), particularly clauses (a) and (c) thereunder which cover schemes to defraud and acts which operate as a fraud in connection with the purchase or sale of any security.

We agree with defendants' statement below that "the facts necessary to the disposition of this motion are fundamentally simple, and undisputed."

In a nutshell:

(1) Prior to the transaction here involved, approximately 95% of Kirby was owned by Santa Fe (80A-81A).

(2) For the sole purpose of getting rid of the minority interest in Kirby, defendants created Forest Products Inc. ("FPI"), a Delaware corporation, on July 11, 1974, to effect a statutory merger with Kirby under the color of the Delaware short form merger statute which authorized effectuation of the merger before notice to and without consent of the minority and provision of payment in cash, as fixed by the fiduciary for the minority shares (80A-81A; 73A-75A).*

(3) <u>Without any notice or disclosure whatsoever to the minority stockholders of Kirby</u>, or consent by them, defendants caused FPI to be merged into Kirby, freezing out the minority, effective July 31, 1974 (80A-81A; 73A-75A).

* See Delaware Corporation Law, §253, quoted at 50A-51A.

(4) By letter of August [illegible], 1974, after the merger had been completed effective the previous day, the minority stockholders of Kirby were first informed by defendants that their only right was to receive a cash payment of $150 per share for their shares that were purchased by Kirby on July 31, 1974 or to seek an appraisal under Delaware law for the fair value of those shares (81A-83A; 74A-75A). The purchase by Kirby on July 31, 1974 was a forced sale by the minority on that date, pursuant to Delaware law, without even the knowledge of such minority stockholders (id).

(5) Prior to the freeze out merger on July 31, 1974, the following significant facts took place:

(i) Appraisal Associates on February 19, 1974 had submitted to the defendants a written appraisal of the land (exclusive of minerals), timber, buildings and machinery belonging to Kirby as of December 31, 1973, stating its market value to be $320,000,000 (62A). The book value of those assets was $9,000,000 (46 A). The difference of $311,000,000 was $622 per share over and above the book value of those assets of Kirby.

(ii) By letter of June 24, 1974 defendant Morgan, with knowledge of that written appraisal, rendered the fraudulent appraisal that the fair market value of the Kirby stock was $125 per share (60A-61A). Defendants, as part of the scheme to defraud the minority stockholders

of Kirby, sought and obtained the fraudulent appraisal from defendant Morgan in order to lull the minority stockholders into erroneously believing that defendants were generous when they fixed a value for the shares of the minority in Kirby at $150, $25 higher than the Morgan appraisal (76A).

(iii) The pro rata value of the physical assets of Kirby was at least $622 more than the $150 fixed by Santa Fe as the forced purchase price for the minority interest (75A). The market value of Kirby as a going concern exceeded the value of its physical assets (75A).

(iv) Defendants schemed to defraud the minority stockholders out of the conceded pro rata value of the physical assets of Kirby in the amount of at least $622 per share, which on the plaintiffs' 143 shares amounted to an appropriation of $88,946 and on the entire class of 25,324 1/2 minority shares outstanding amounted to an appropriation of $15,751,839 (76A).

(6) The above transaction, whereby the dominant stockholder, a fiduciary, fleeced the minority, its cestuis, in the purchase and sale of securities, implemented by the use of means of instrumentalities of interstate commerce including U.S. mail and telephone, constituted a plain violation of Rule 10b-5 under the settled authorities (76A).

Argument

Point I

THE SHORT FORM MERGER - FREEZING OUT THE MINORITY AT LESS THAN 1/5th THE VALUE OF THEIR STOCK, WITHOUT PRIOR NOTICE TO OR CONSENT BY THEM AND FOR THE PROFIT OF THE MAJORITY STOCKHOLDER, A FIDUCIARY, AT THE EXPENSE OF ITS MINORITY STOCK-HOLDER-CESTUIS - WAS A FLAGRANT SELF-DEAL WHICH OPERATED AS A FRAUDULENT DEVICE AND AN ACT IN VIOLATION OF CLAUSES (1) AND (3) OF SEC RULE 10b-5.

A. The Breach By Santa Fe, The Fiduciary

Rule 10b-5 outlaws the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of any security,*

* The purchase-sale here, undisputedly falls within the coverage of the Rule, Vine, supra, at 634; Schlick v. Penn-Dixie Cement Corp., 507 F2d 374, 381 (C.A.2); as does the means used (76A).

"(1) to employ any device, scheme or artifice to defraud,

"(2) [to make a material misstatement or omission] or

"(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person."

Here, Santa Fe, the majority stockholder, deliberately froze out the minority for less than 1/5th the value of their stock, in a short merger, effectuated without notice to or consent by them. This was a flagrant self-deal by a fiduciary at the expense of its beneficiaries. As such it was clearly a fraudulent scheme under clause (1) of Rule 10b-5 and an act operating to deceive under clause (3) of the Rule. Supt. of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6; Schoenbaum v. Firstbrook, 405 F2d 215 (C.A.2 en banc), cert. denied, 395 U.S. 906; Drachman v. Harvey, 453 F2d 722,736 (C.A.2) (en banc); Popkin v. Bishop, 464 F2d 714 (C.A.2); Pappas v. Moss, 393 F2d 865 (C.A.3); Shell v. Hensley, 430 F2d 819 (C.A.5); Dasho v. Susquehanna Corp., 380 F2d 262 (C.A.7); Levine v. Biddle Sawyer Corp., 383 F.Supp. 618 (S.D.N.Y.), Securities Law Rep. ¶94,816 (S.D.N.Y. 10/7/74); Voege v. Amer. Sumatra Tobacco Corp., 241 F.Supp. 369 (D. Del.); Bailey v. Meister Brau, 378 F.Supp. 869 (N.D. Ill.).

Thus, in Schoenbaum, supra, this Court held as follows (218-19):

> "In the present case the plaintiff's allegations constitute a claim that Aquitaine, knowing the true value of Banff stock, used its control over Banff to acquire 500,000 shares at a vastly inadequate price. The allegations have a sufficient factual basis - Aquitaine's control, Aquitaine's knowledge of the oil discovery, the inadequacy of the price paid for the stock - to require at least that the plaintiff be permitted through discovery to develop the evidence to counter defendants' affidavits.
>
> * * * *
>
> "We hold that the complaint states a triable claim under section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ..."

Here, like Schoenbaum, Santa Fe, knowing the true value of Kirby, created FPI and used its control over Kirby to merge FPI into Kirby and thus have Kirby acquire the 25,234 1/2 minority shares in Kirby at a vastly inadequate price. Here, we have all the necessary ingredients of a fraudulent scheme as in Schoenbaum, to wit, "control, [Santa Fe's] knowledge [of the underlying pro rata value of the physical assets of Kirby], the inadequacy of the price paid for the stock ..."

Judge Hays dissented in part from the panel's decision in Schoenbaum, 405 F2d 200 (C.A.2), then wrote the opinion for the en banc Court in Schoenbaum which essentially followed his dissenting panel opinion. In that earlier opinion, Judge Hays stated (215):

> "What we have here then is a scheme by which the directors of Banff gave to the controlling stockholder (footnote omitted) and an affiliated corporation some millions of dollars worth of the corporation's property. A plainer case of fraud would be hard to find."

Our facts are *a fortiori*. The defendants appropriated at least $15,751,839 from the minority stockholders in the "forced sale" of their securities under the freeze out: "A plainer case of fraud would be hard to find."

In *Drachman v. Harvey*, *supra*, this Court sustained a claim under Rule 10b-5 based on the fiduciary's causing the corporation to make an improvident redemption of its convertible debentures. The Court followed *Supt. of Insurance*, *supra*, where the Supreme Court, noting that "Section 10(b) must be read flexibly, not technically and restrictively" (12) and that protection of the integrity of the securities markets and of investors along with protection against "disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web" (11-12), held that a fiduciary would be liable under Rule 10b-5 for pocketing the proceeds of a sale of his cestui's bonds. Thus, whether the cestui is overreached with respect to some or all of the value in a purchase or sale of securities, a valid claim is stated against the faithless fiduciary under clauses (1) and (3) of Rule 10b-5. That express misstatements and express

statements with misleading omissions did not accompany the overreaching is, of course, immaterial. As this Court held recently in Competitive Associates, Inc. v. Laventhol, et al., (C.A.2, 5/8/75) sl. op. 3475, at 3481:

> "Not every violation of the anti-fraud provisions of the federal securities laws can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws."

In Popkin v. Bishop, supra, this Court stated (719):

> "It is also true that in such decisions as Drachman and Schoenbaum, which involve what has been called the 'new fraud,' (footnote omitted) this court has focused on whether improper self-dealing itself can be a proper basis for a Rule 10b-5 action. (footnote omitted) In many, if not most, corporate self-dealing transactions touching securities, state law does not demand prior shareholder approval. In those situations, it makes sense to concentrate on the impropriety of the conduct itself rather than on the 'failure to disclose' it because full and fair disclosure in a real sense will rarely occur. It will be equally rare in the legal sense once the view is taken - as we did in Schoenbaum - that under federal securities law disclosure to interested insiders does not prevent a valid claim that fraud was committed upon 'outsiders' (such as minority shareholders) whatever the requirements of state corporate law may be."

Thus, Popkin clearly supports a Rule 10b-5 action where, as here, "state law does not demand prior shareholder approval" and "[i]n those situations, it makes sense to concentrate on

the impropriety of the conduct itself rather than on the 'failure to disclose' it ..."

Levine, supra, like our case,involved a short merger and freeze-out at an alleged inadequate price - a "merger ... conducted in secret and without notice to the plaintiffs until after the fact." Sustaining the complaint under Rule 10b-5, the District Court relied on Popkin, supra:

> "The Court of Appeals has counseled that in situations where state law does not require prior shareholder approval, 'it makes sense to concentrate on the impropriety of the conduct itself rather than on the failure to disclose it because full and fair disclosure in a real sense will rarely occur.' Popkin v. Bishop, 464 F.2d at 719." (622)

Voege, too, involved a short form merger freeze-out at an inadequate price, held by the District Court (Delaware) to be a violation of Rule 10b-5:

> "It may be conceded that Rule 10b-5 is inapplicable unless a seller has been deceived. See O'Neill v. Maytag, 339 F2d 746 (2nd Cir. 1964). Plaintiff at bar was the subject of deception for when she acquired her stock she did so upon the justifyable assumption that any merger would deal with her fairly, only later to find, according to the complaint, that the terms of the merger were designed to defraud her." (375)

In Pappas v. Moss, supra, at 869, the Third Circuit held that:

> "where, as here, a board of directors is alleged to have caused their corporation to sell its stock to them and others at a fraudulently low price, a violation of Rule 10b-5 is asserted."

In Shell v. Hensley, supra, the Fifth Circuit Court of Appeals held that the unfair use of controlling influence in the purchase or sale of securities spells out a fraud under Rule 10b-5 without regard to what information was imparted. The Court stated in this connection as follows (827):

> "When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. We can make no meaningful distinction between this situation and the one at hand. When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of all the material information known to the other party to the transaction."

Likewise in our case the forced sale at an unconscionable price disabled the minority stockholder-cestuis from "a choice of action ... possessed of all the material information known" to the fiduciary making the self-deal.

In Dasho, supra, the concurring Seventh Circuit majority held, in sustaining a complaint under Rule 10b-5, with respect to a merger allegedly on unfair terms (270):

> "I do not believe it is sound to differentiate between situations where the directors were unanimous in wrong-doing and those where less than all were involved."

In our case, the majority stockholder, acting on its own, effected the merger on wrongful terms.

In Bailey, supra, the District Court (N.D. Ill.) held: in causing the corporation to participate in an unfair securities transaction, in which the controlling stockholders had a conflict of interest, the controlling stockholders (and the corporate directors) violated 10b-5 citing Superintendent of Insurance v. Bankers Life, 404 U.S. 6, 12. The unfairness consisted in the disproportionate values.

The flagrant self-deal whereby the defendant fiduciary, Santa Fe, completely on its own, effected a merger, without prior notice to the minority, expropriating their interest at less than 1/5th the fair value - $150 per share for stock worth at least $772 per share, for existing values - constituted a clear violation of Rule 10b-5 under the settled authorities.

Moreover, without prior notice to or consent by the minority, they were deprived of their equity interest in the present value of the potential of a profitable, going concern. In Lebold v. Inland Steel Co., 125 F2d 369, 136 F2d 876 (C.A.7) the insiders were held liable for having used dissolution proceedings (authorized by statute) for the purpose of eliminating minority stockholders from the profits to be made from the continuation of a going concern.* Lebold requires the fiduciary to pay more than physical asset value; in our case the fiduciary has determined to pay less than physical asset value.

Santa Fe is itself a public corporation with outside stockholders; that was not changed by the merger of a dummy corporation into Kirby. All that happened was that a public

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* The Court of Appeals stated (at 375):

> "Henry Ford could not rightfully say to one of the stockholders who invested in the Ford automobile company in its beginning and whose investment had multiplied thousands of times in value, that in view of the handsome returns he had upon the investment, he must deliver the stock to Mr. Ford upon receipt of his pro rata share of the value of the physical assets of the Ford Company or Mr. Ford would dissolve the company and bid in the assets and deprive him of any returns."

entity squeezed out some members of the public and continued as a public going concern. Santa Fe, had it acted in good faith and without intent to overreach in the merger, could have offered the Kirby minority Santa Fe stock, taxfree, and thus a continuing interest in the enterprise - this is recommended by Professor Arthur H. Borden, Going Private - Old Tort, New Tort or No Tort? N.Y.U. Law Rev. Preprint (1974), at 1018-9. Here, the majority stockholder arranged the security transaction in such way as to be tax-free to itself but not to the minority, who, receiving cash, must report and pay a capital gains tax (75A). This disparate treatment favoring the fiduciary and discriminating against the cestui, without notice or compensation to or consent by the minority, was further fraudulent overreaching in violation of Rule 10b-5.

The District Court stated (87A):

> "For purposes of this motion the Court accepts plaintiffs claimed valuation ..."

Plaintiffs alleged (75A) that the stock was worth at least $772 per share by contrast to the $150 - or less than 1/5th - fixed as the price by the fiduciary for its cestui's stock. It is, therefore, not tenable to assert, as does the opinion below (89A), that the "complaint demonstrates merely that

the parties to this action differ in their computation of the fair value of the plaintiffs' shares." With $150 offered as against $772 the "accepted" value, plainly we are not dealing with a mere difference of computation.* And, contrary to the Opinion below (89A), the "inadequacy of the offering price" does not "stand ... alone". What we have is an unconscionable disparity between the fair price and the price the fiduciary would pay its cestui in a sale forced by the fiduciary in its own selfish interest. And that, under the authorities cited supra, does demonstrate bad faith and overreaching. As Judge Cardozo stated long ago in the classic case of Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 490 as to a contract set by a corporate fiduciary sitting on both sides of the bargaining table:

> "There was, then, a relation of trust reposed, of influence exerted, of superior knowledge on the one side, and legitimate dependence on the other (Sage v. Culver, 147 N.Y. 241, 247 ...) ... A trustee may not cling to contracts thus won unless their terms are fair and just ... His dealings with his beneficiary are 'viewed with jealousy by the courts, and may be set aside on slight grounds" (Twin Lick Oil Co. v. Marbury, 91 U.S. 587, 588). He takes the risk of an enforced surrender of his bargain if it turns out to be improvident. There must be candor and equity in the transaction, and some reasonable proportion between benefits and burdens."

And the classic case of Pepper v. Litton, 308 U.S. 295, 306-7 sets forth the applicable "cardinal principles of equity jurisprudence" as follows:

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* In fact, the $772 is the pro rata value of the physical assets as appraised by defendants' experts.

> "A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. [footnote and citations omitted]*

Rule 10b-5 is, as the authories above show, applicable to the breach of fiduciary obligation involved in the purchase-sale of a security at an unconscionable price. The interrelationship between the state-created duty and the applicability of Rule 10b-5 is set forth by Professor Borden, *supra*,

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* The case cited below (89A), *Muschel* v. *Western Union Corp.*, 310 A2d 904 (Del. Ch. 1973), does not stand for any inconsistent proposition. Western Union acquired a corporation not under common control; there being no self-deal (907), of course the business judgment rule applied under which the Western Union board could decide how much it would pay without legitimate complaint by its plaintiff stockholders (908). In our case, since we are concerned with a self-deal, the *Pepper* v. *Litton* rule applies, under which the "inadequacy of the offering price" does not "stand alone" and does "demonstrate bad faith or overreaching on the part of the controlling interests."

at pp. 1036-7 as follows:

> "Examination of federal-court enforcement of fiduciary standards reveals that, almost without exception, the breaches of fiduciary duty found subject to federal scrutiny have involved economic unfairness either in the securities transaction or in the entire transaction of which the securities transaction was an integral part.
>
> "These cases have all reflected the accepted rule that fiduciaries are not supposed to do in their cestuis. Federal courts have been willing to extend jurisdiction under rule 10b-5 to corporate mismanagement, but only upon a showing of economic unfairness with either deception or conflict of interest alleged. ... [or as] found in Drachman v. Harvey, ... for the alleged improper purpose of ensuring corporate control.
>
> * * *
>
> "Here we come to the heart of the problem. The impropriety of doing in one's cestuis or of using corporate power to shift or ensure control has long been recognized at common law. Federal courts, in making their machinery available to complainants in these cases, do not challenge the leading role of state courts in the delineation of fiduciary standards for corporate management." (footnotes omitted)

Professor Borden concluded in the article cited above,

> "Interested parties should be exposed to equitable and legal remedies in class action suits in both federal and state courts when the [merger] proposal is on unfair terms." (1041)

The fiduciary's forced appropriation of its cestui's stock in a secret self-deal, unconscionably taking without compensation physical values, going concern value,

and disciminatorily imposing taxes on the beneficiaries escaped by the fiduciary, is clearly fraudulent under the authorities and a plain violation of Rule 10b-5.

B. Post-Merger Notice Too Late For State Court Preventive Relief; Hence No Defense Under Popkin

Only after the merger had become effective, purporting to deprive the minority of their stockholder status and giving them the right to receive less than 1/5th the value of their stock or seek an appraisal, did defendants give notice to the minority of the consummated overreaching. That notice, defendants say, absolved them of any violation of Rule 10b-5. And they rely for this proposition on Popkin v. Bishop, supra, 464 F2d 714 (C.A.2). We submit that defendants and the District Court have misconstrued this Court's holding and reasoning in Popkin. Popkin, as Judge Feinberg's opinion therein makes clear, set up a narrow exception to Schoenbaum and Drachman; viz. where

(1) "merger transactions ..., under state law, must be subjected to shareholder approval", and

(2) "shareholder approval is fairly sought and freely given [i.e.] defendants fully and fairly disclosed all material facts surrounding the merger to all interested parties, including the minority shareholders",

then

(3) "appellant's claim under Rule 10b-5 for injunctive relief must fall" because

(4) "armed with the information fully disclosed under compulsion of the federal proxy regulations and Rule 10b-5, appellant was placed in a position to sue under state law to enjoin the merger as unfair."

(5) Only under the above circumstances is Schoenbaum's and Rule 10b-5's concern for fairness of the terms fixed by the fiduciary set aside. (720)*

Plainly, the merger here in question does not come within the exception recognized by Popkin. Unlike the Popkin transaction, (1) the Delaware short form merger statute did not condition the Kirby merger on shareholder approval; (2) shareholder approval of the Kirby merger was not sought and no prior disclosure of the facts was made to the interested minority; (3) the present claim, necessarily coming after the secret merger was effected, cannot and does not ask for preventive relief, (4) since no prior information was given and the merger was effectuated secretly, the minority did not

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* In Drier v. The Music Makers Group, Inc., CCH Federal Securities Law Reports, ¶94,406, too (relied on below, 89A-90A), the transaction was completely open, since it was "At the annual shareholders' meeting of Music Makers Group on March 14, 1972, [that] the individual defendants voting Lehigh Group's controlling interest in Music Makers Group approved a merger of the two companies."

have the advantage conferred by the federal proxy rules and Rule 10b-5 and so were not placed in a position under state law to enjoin the merger as unfair. (5) Thus the disclosure sought to be compelled by Rule 10b-5 did not occur; hence "it makes sense to concentrate on the impropriety of the conduct itself" as the basis for the 10b-5 violation. (719)

Putting Schoenbaum and Popkin together, a 10b-5 violation is established by the fiduciary's overreaching his cestui in a security sale-purchase, unless enough facts are disclosed in advance by the fiduciary to enable the cestui to prevent the transaction as unfair by state court injunction. Defendants, of course, concede that such pre-merger disclosure was not made. Contrary to the opinion below, the post-merger notice could not be "adequate disclosure" (90A) or "Full and fair disclosure" (91A), under Schoenbaum and Popkin, since it came after the effectuation of the merger, too late for state court preventive relief. Moreover, the decision below commits the error warned against in the recent Competitive Associates, Inc. v. Laventhol, et al., (C.A.2, 5/8/75) Sl. op. 3475, at 3481:

> "Not every violation of the anti-fraud provisions of the federal securities laws can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws."

Contrary to the opinion below (86A), Delaware's provision of an appraisal procedure does not limit the application of Rule 10b-5. As this Court stated in Popkin, supra (at 718):

> "Where Rule 10b-5 properly extends, it will be applied regardless of any cause of action that may exist under state law 15 U.S.C. §78bb; see Vine v. Beneficial Finance Co., supra, 374 F.2d at 635-636.

Thus, "plaintiffs right to appraisal under state law does not negate their claims under federal law. [citing Vine and Popkin]" Levine v. Biddle Sawyer Corp., supra, 622*

Moreover, it is clear that appraisal is not an adequate remedy for the fiduciary's overreaching in this case: (1) the appraisal procedure does not permit of equitable relief e.g. to set aside the fictitious "merger" and restore to the minority their equity interest in the enterprise**; (2) the appraisal procedure does not permit a class action where members of the minority, especially small stockholders, can give mutual support and obtain a more extensive discovery and hearing; (3) the appraisal procedure has jurisdictional, venue, time and procedural limitations that hamper the stockholder and finally (4) as set forth in a recent article, Fair Shares In Corporate Mergers and

* Accord: Swanson v. Amer. Consumer Indus., Inc., 415 F2d 1326, 1332-3 (C.A.7); Miller v. Steinbach, 268 F.Supp. 255, 269-71 (S.D.N.Y.); Voege v. Amer. Sumatra Tobacco Corp., 241 F.Supp. 369, 374-5 (D. Del.).

** Swanson v. Amer. Consumer Industries, Inc., 415 F2d 1326, 1333 (C.A.7): "Nor is it clear that appraisal rights would offer complete relief for a complaint which asks that a merger be unscrambled"

Takeovers, 88 Harv. Law Rev. 297 (Dec. 1974), Professors Brudney and Chirelstein conclude that the individual right of appraisal is inadequate in the fiduciary-cestui setting (at 306-307):

> "In summary, our view is that the individual right of appraisal is not directly responsive to the problem of fiduciary abuse in mergers between parents and subsidiaries. Appraisal is predicated more on the conception of managerial incompetence in valuing the old enterprise and negotiating a price for it than on the notion of a conflict of interest which results in a diversion of a portion of the merger proceeds to a controlling parent. Moreover, it neither imposes its cost solely on the stockholders of the acquiring company nor seeks to reimburse all the victims of the inadequate merger price, that is, all the public stockholders of the acquired company. Finally, appraisal is merely an option-out alternative, and as such it focuses on the premerger value of the acquired company's shares. In short, it neither serves nor is designed to serve as a remedy for the fiduciary misbehavior at which the fairness challenge is directed." (footnotes omitted)

A dramatic illustration of the value yielded by "appraisal" and the much higher value in a federal securities law case is afforded by the recent decision of this Court in Chris-Craft Industries, Inc. v. Piper Aircraft Corp., (C.A.2, 4/11/75) Slip op. 2829 at 2831, 2842, 2846, and 2859: the "appraisal" value recovery was fixed by the District Court at $1,673,988 and the recovery set by this Court on appeal, holding that "appraisal" was an erroneous approach in a federal securities law case, was $25,793,365.

The SEC now has under consideration proposed rules to outlaw unfair or arbitrary freeze-outs. But contra the Opinion below (91A-92A), that has no bearing on the meaning of Rule 10b-5. Thus, the SEC, in publishing the proposed rules for comment, issued the following caveat not mentioned in the Opinion below (SEC, "Securities Act of 1933", Release No.5567, February 6, 1975, p.2):

> "These rule proposals are in no way intended to limit the present applicability of existing provisions of the Federal securities laws and the rules and regulations promulgated thereunder relating to 'going private' transactions."

It is, of course, elementary that introduction of a bill (or even subsequent passage) in no way implies what the existing law is. Connell Construction Co. v. Local 100, U.S. , 43 U.S.L.W. 4657, 4663, n.16(6/25/75); U.S. v. Phila. Nat. Bank, 374 U.S. 321.*

The District Court also ignored SEC Commissioner A.A. Sommer, Jr.'s opinion set forth in his November 14, 1974, address, "Going Private: A Lesson In Corporate Responsibility", as follows:

> "I believe that federal courts will increasingly be inclined to find in Rule 10b-5 the basis for concluding that the conduct which is at the heart of 'going

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* In Phila. Nat. Bank, supra, at 349, the Court noted that legislative "misunderstanding of the scope of [existing law] may ... play ... some part in the passage of the [subsequent] Act", and stated further, at 348-9: "The views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one."

"private' violates federal securities laws." (op cit p.13)

* * *

"In my estimation, it is no longer possible for this overreaching to enjoy the protection of the mechanical provisions of state law. Increasingly the courts are correcting the deficiencies of state law by imaginative applications of federal securities law, particularly Rule 10b-5 which makes it unlawful to employ any device, scheme or artifice to defraud or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of securities." (p.14)

* * *

"There are circumstances when business considerations (and I would not include among these avoiding the cost and bother of SEC compliance and shareholder servicing) may be sufficiently compelling to justify visiting upon public shareholders diminished liquidity, less protection from the federal securities laws, or even compelling that they give up their investment, but I would suggest that should only be done after the most searching inquiry into the purported purpose and a sensitive balancing of the interests of the shareholders." (p.16)

* * *

"We are witnessing a significant raising of the standards of corporate responsibility, including the responsibility of those who manage and control corporate wealth toward their junior partners. The shareholder must no longer be a second class citizen. Once he is invited to feast and he pays his admission, those who own the tent must not be able to usher him out at the end of the second course with only the menu as his souvenir. While the argument about the broader meanings of corporate responsibility continues, in this one area the responsibility is clear. The ethical implications are clear; so are the legal." (p.18)

C. <u>Morgan As Aider And Abettor</u>

The amended complaint alleges, also, that "With knowledge of the above values [pro rata value of the physical assets of Kirby was at least $772 per share and fair value of the company at least as much], the defendants as part of the scheme obtained and submitted a fraudulent appraisal from defendant Morgan Stanley & Co., a co-partnership, valuing each share of stock of Kirby at $125 per share and in order to lull the minority stockholders into erroneously believing that defendants were generous, fixed a value $25 higher than the Morgan Stanley & Co. appraisal, to wit, $150 per share. ... Morgan, Stanley & Co. is liable ... as an accessory in that it knowingly assisted and facilitated such fraud by submitting an appraisal of the stock at $125 per share even though said defendant knew the pro rata value of the physical assets of Kirby was at least $772 per share." (76A).

Thus Morgan stands liable for aiding and abetting the fiduciary in its fraudulent scheme to expropriate the minority at an unconscionable price.

D. <u>The Complaint Complies With FRCP Rule 9(b)</u>

The complaint alleges that the majority stockholder, by the short-form merger, froze out the minority at $150 per share when the fair value of the stock was at least $772,

witness that Kirby's physical assets were worth at least $772 per share and its value as a going concern was at least that amount; and that defendants procured Morgan to say that the stock was worth $125 to give a pretended generosity to the $150 price. Under the authorities cited above, that spells out a fraud under Rule 10b-5; so plainly the complaint satisfies Rule 9(b), FRCP which simply requires that "the circumstances constituting fraud or mistake shall be stated with particularity." Here the "circumstances constituting fraud" are the secret squeeze-out by the fiduciary of the cestui at an inadequate price. Defendants are certainly given "adequate notice" by this to "enable [them] to prepare a responsive pleading", which is the basic consideration in passing on the particularity required of a pleading. 5 Wright and Miller, Federal Practice and Procedure §1298 [Pleading Fraud With Particularity] - Extent of Requirement, p.415.

All of the material allegations in Schoenbaum, supra, that sufficiently spell out a claim under Rule 10b-5 are present in our complaint. Likewise, Levine, supra, supports the sufficiency of the present complaint under FRCP 9(b).

In Schlick v. Penn-Dixie Cement Corp., 507 F2d 374 (C.A.2), the Court of Appeals reversed the district court's holding that a particular count was defective because it

contained "only conclusory allegations without any specific allegations of fraud or deception as required to support a 10(b) claim." (378) The Court of Appeals, after reviewing the allegations, stated:

> "In any event, Rule 9 must be construed in conjunction with Rule 8 (id.) (Carroll v. First National Bank of Lincolnwood, 413 F.2d 353, 7th Cir., 1969, cert. denied 396 U.S. 1003, 1970), and a complainant is not required to plead evidence (Brady v. Games, 128 F.2d 754, 755, D.C. Cir., 1942; Collins v. Rukin, 342 F. Supp. 1282, 1292, D. Mass., 1972). We consider Rule 9 sufficiently complied with here." (379)

In Dudley v. Southeastern Factor & Finance Corp., 446 F2d 303, 308 (5th Cir.), the Court held that the allegation of a scheme to freeze the plaintiff out on unfair terms states a claim under Rule 10b-5 with sufficient particularity to comply with FRCP 9(b).

In A.T. Brod & Co., 375 F2d 393, 398 (C.A.2), the Court of Appeals held:

> "It is true, of course, as the Perlows submit, that Brod has not proven that the Perlows' failure to make payment constituted a 'device, scheme, or artifice to defraud.' Indeed, we recognize that not every failure by a customer to pay for securities ordered adds up to a violation of the securities laws. But, whether there is actionable fraud or a mere breach of contract depends on the facts and circumstances developed at the trial or on motion for summary judgment. Brod was not required to prove in its complaint that it was entitled to an ultimate recovery, nor was it required to set forth in its complaint a detailed statement of the facts. Rule 8(a) of the Federal Rules of Civil Procedure requires only that a

"complaint contain '(1) a short and plain statement of the grounds upon which the court's jurisdiction depends * * * (2) a short and plain statement of the claim showing that the pleader is entitled to relief, and (3) a demand for judgment for the relief to which he deems himself entitled." Such simplified 'notice pleading' requires that the complaint be construed liberally, see Conley v. Gibson, 355 U.S. 41, 78 S. Ct. 99, 2 L.Ed.2d 80 (1957); Dioguardi v. Durning, 139 F.2d 774 (2d Cir. 1944); and 'jurisdiction * * * is not defeated * * * by the possibility that the averments might fail to state a cause of action on which * * * [the pleader] could actually recover.' Bell v. Hood, 327 U.S. 678, 682, 66 S.Ct. 773, 776, 90 L.Ed. 939 (1946).

"The pleading rules, designed to avoid and reduce long and technical allegations, are necessarily supplemented by procedures, including summary judgment, which enable a party to have a judgment in a relatively short time if there is actually no bona fide claim presented. (footnote omitted) The Perlows are at liberty to avail themselves of these procedures and thereby seek to avoid what otherwise might be protracted litigation. But accepting Brod's allegations as true, as we have indicated we must on a motion to dismiss the complaint, it is clear that the complaint sufficiently stated a claim grounded in federal jurisdiction. The order and judgment of the District Court dismissing the complaint for lack of subject matter jurisdiction must, therefore, be vacated and reversed." (footnote omitted)

Defendants argued below: "No deception is specified." The secret squeeze-out of the cestui at a grossly disproportionate price is the deception, which, under the authorities cited, contravenes Rule 10b-5. Defendants are simply rearguing their basic, untenable position under Rule 10b-5, in the guise of an FRCP 9(b) contention, equally untenable.

Since the "circumstances" constituting defendants' fraud are alleged with particularity, FRCP 9(b) itself permits their "knowledge" to "be averred generally." Hence there is no substance to defendants' contention that Morgan's "knowledge" of the insufficiency of the $125 is not spelled out with added particularity. Moreover, plaintiff alleged the basis for defendants' knowledge, namely, "the defendants' own appraisal [of the land and timber] at $320,000,000" instead of a book value of the physical assets of Kirby of at least $772 per share" and "The value of the stock was at least the pro rata value of the physical assets." (75A). The defendants, including Morgan, knew the above and "defendants as part of the scheme obtained and submitted a fraudulent appraisal from defendant Morgan Stanley & Co. ... valuing each share of stock of Kirby at $125 per share and in order to lull the minority stockholders into erroneously believing the

defendants were generous, fixed a value $25 higher than the Morgan Stanley & Co. appraisal, to wit, $150 per share." (76A)

Defendants' own exhibit in their moving papers (60A) showed that Morgan had "reviewed the written appraisals of the Company's properties ... which were ... performed by Appraisal Associates ..." The appraisal of Appraisal Associates (62A-63A) sets a fair market value on the land and timber at $320,000,000 - all of which is support for the factual allegations of paragraph 7 and 9 of the amended complaint (75A-76A).

Accordingly, contra defendants, the minority stockholders, by seeking a remedy for defendants' misappropriation of their $15,000,000 are not engaging in an "unfounded strikesuit."

The allegations of the complaint are adequate, particularly in light of the rule of Pepper v. Litton, supra, that "the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."* This is particularly so where the merger and freezeout are without any notice to or approval by the minority and particularly where the merger

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* As Professor Borden, supra, stated (1022):

> "In view of the fact that such transactions [viz. mergers] do afford opportunities for abuse some statutes, the common law and every dictate of good sense require that the burden of proof as to fairness be placed upon the interested parties [footnotes omitted]".

has no business purpose.* With such freezeout "presumptively deemed to be at an unfair price" (Borden, supra, at 1018), it becomes entirely out of place for the complaint to give in detail evidence of the fair values. Accordingly, the District Court correctly held (87A) that it must accept plaintiffs' claimed valuation of $772 per share for purposes of the motion.**

E. The Requirement of Causation Is Satisfied.

As the Opinion below states (93A),

> "there must be some causal connection between the wrong done and the harm suffered."

Here that causal connection is self-evident: the unconscionable price inflicted by the fiduciary on the cestui, "the wrong done", is itself "the harm suffered". This is "causation in fact" which is sufficient where, as here in the forced sale, affirmative misrepresentations are not a necessary

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* We need not argue that every short form merger without business purpose is in violation of Rule 10b-5; the gravamen of our complaint is that the price is unconscionable - a violation whether or not it has a business purpose.

** Inconsistently therewith, however, the District Court questioned "the propriety of using the liquidation value of Kirby's physical assets as the sole basis for determining the true worth of the shares" (87A). In the first place, the plaintiffs did not use the liquidation value of Kirby's physical assets as the sole basis; they in fact alleged that the market value of Kirby as a going concern was at least as much as the value of the physical assets (75A, ¶7). Moreover, where non-operating business assets have a higher market value than if used in the business, the higher market value is determinative, Hicks v. U.S., 486 F2d 325, 327 (C.A.10), at least where the fiduciary is forcing a sale on the cestui. In addition, other value ingredients must be taken into account; e.g. the avoidance of capital gains tax by retaining shares or exchanging for shares in a merger.

ingredient in the violation, Competitive Associates, Inc. v. Laventhol, et al., supra, slip op. 3475, 3480-1 and Schlick, supra. In Schlick, the Court of Appeals sustained a claim under Rule 10b-5 with respect to a merger and overruled the defendants' objection as to lack of causation in the following language (507 F2d, at 380-1):

> "This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both loss causation - that the misrepresentations or omissions caused the economic harm - and transaction causation - that the violations in question caused the appellant to engage in the transaction in question.
>
> "The former is demonstrated rather easily by proof of some form of economic damage, here the unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more. In a misrepresentation case, to show transaction causation a plaintiff must demonstrate that he relied on the misrepresentations in question when he entered into the transaction which caused him harm (2 Bromberg sec. 8.6, at 209-11). In an omission or nondisclosure case based upon Rule 10b-5, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material 'in the sense that a reasonable investor might have considered them important' in making his investment decisions (Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54, 1972; see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 240, 2d Cir., 1974).

> "Under the 10b-5 count, proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms, of which the proxy omissions and misrepresentations are only one aspect. (footnote omitted) Thus, appellant need only show loss causation with respect to his claim for relief under 10b-5; Judge Metzner found and we agree that this has been shown. Here the complaint clearly alleges that, as a result of the merger, appellant was forced to sell his Continental shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated market value of Continental stock, and that he sustained injury accordingly.
>
> * * *
>
> "Thus, the complaint completes the showing necessary to state a claim under Rule 10b-5, it alleges a specific scheme to defraud (a scheme which includes the proxy solicitation as a part, but which included substantial collateral conduct as well); the fraud was accomplished in connection with a securities transaction; the appellant was a seller in that transaction; and as a result of the sale, appellant alleges a loss was sustained."

Since "loss causation" is shown, namely, the unconscionable price foisted on the Kirby minority by the Santa Fe fiduciary, without reference to "misrepresentations", that sufficed under Schlick, supra, and Competitive Associates, which follows it.

The deception and fraud took place on and before July 31, 1974 culminating in plaintiffs' forced sale of their stock at $150 per share. Under the fraud alleged, the wrong-

doers did not call for any voluntary act on the part of plaintiffs on or before July 31, 1974. Therefore, where the wrongdoers by their scheme preempt plaintiffs from acting, so-called "transaction cause" and reliance by plaintiffs need not be shown. Thus Vine, supra (at 635) also supports plaintiffs' position:

> "Whatever need there may be to show reliance in other situations, see List v. Fashion Park, Inc., 340 F.2d 475, 462-464 (2d Cir.), cert. denied, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965); Rogen v. Ilikon Corp., 361 F.2d 260, 266-268 (1st Cir. 1966), we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer. Since the complaint alleges that plaintiff, in effect, has been forced to divest himself of his stock and this is what defendants conspired to do, reliance by plaintiff on the claimed deception need not be shown."

In Voege, supra (at 375-6), too, the Court held that a freezeout by the insiders of the minority at an inadequate price shows causation sufficient for a violation of Rule 10b-5. Since "the result of a forced sale is exactly that intended by the wrongdoer", the Opinion below erred in holding (94A) that plaintiff also had to show some additional fraud antecedent to the fraud involved in the unconscionable price fixed by the fiduciary for the Kirby minority in the sale the fiduciary forced on that minority in the fiduciary's selfish interest.

The District Court refers in this connection to "alleged misrepresentation," not being relied upon, thereby misinterpreting the plaintiffs' claim. Plaintiffs are not alleging "misrepresentations"; plaintiffs are alleging a "scheme ... to defraud" in violation of clause (1) and an "act ... which operates ... as a fraud" in violation of clause (3), of Rule 10b-5, and, pursuant to Competitive Associates, supra, decline to have their case "forced into a category headed 'misrepresentations' or 'nondisclosures'". With that case, we urge that "Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws," specifically Rule 10b-5.

Point II

SINCE SEC RULE 10b-5 PROVIDES AN INDEPENDENT BASIS OF FEDERAL JURISDICTION OVER DEFENDANT-APPELLEE MORGAN, THE DISTRICT COURT ALSO HAD DIVERSITY JURISDICTION WITH RESPECT TO THE STATE CLAIM AGAINST SANTA FE, THE DIVERSE DEFENDANTS-APPELLEES.

The original complaint set forth only the federal jurisdiction claim under Rule 10b-5. After the defendants moved to dismiss the complaint on the ground of failure to state a claim, the plaintiffs filed an amended complaint,

as of right, which was basically the same as the original complaint with respect to the federal question under 10b-5 and which added a diversity jurisdiction claim. The amended complaint (72A, ¶1) made it clear that all the defendants were involved with respect to the federal jurisdiction claim but only Santa Fe, and not Morgan, were involved with respect to the diversity claim, because Kirby was diverse as to the plaintiffs but Morgan was not (73A, ¶2 and 4). It was stipulated that the motion of the defendants to dismiss would be deemed applicable to the amended complaint. The defendants, however, never contended that the amended complaint was defective in alleging diversity jurisdiction with respect to Santa Fe.

The District Court sua sponte, relying on the classic rule of Strawbridge v. Curtiss, 3 Cranch 267 (U.S. 1806), dismissed the amended complaint, diversity claim, as to Santa Fe because there was no diversity between the plaintiffs and defendant Morgan (95A). In so ruling, without giving the plaintiffs an opportunity to call its attention to the subsequent law on the subject, the District Court overlooked the fact that since SEC Rule 10b-5 provides an independent basis of federal jurisdiction over Morgan, the complaint is permitted to combine with that a diversity claim against Santa Fe, the diverse defendants. This was squarely held by the Supreme Court in Romero v. International Term. Operat. Co.,

358 U.S. 354. There the Supreme Court expressly limited the rule of <u>Strawbridge</u>, and held as follows (at 381):

> "Respondents Garcia & Diaz and Quinn Lumber Company, New York corporations, and International Terminal Operating Company, a Delaware corporation, are of diverse citizenship from the petitioner, a Spanish subject. Since the Jones Act provides an independent basis of federal jurisdiction over the non-diverse respondent, Compania Trasatlantica, the rule of Strawbridge v. Curtiss (US) 3 Cranch 267, 2 L ed 435, does not require dismissal of the claims against the diverse respondents. Accordingly, the dismissal of these claims for lack of jurisdiction was erroneous."

With respect to the diverse defendants, it was, of course, proper to rely on both federal question and diversity jurisdiction. <u>Reed & Martin</u> v. <u>Westinghouse Electric Corp.</u>, 439 F2d 1268, 1275-6 (C.A.2).

Accordingly, the District Court committed error in dismissing the state claim against Santa Fe on the asserted ground of no diversity jurisdiction.

<u>Point III</u>

AS TO THE STATE CLAIM (UNDER PENDENT AND DIVERSITY JURISDICTION), EQUITABLE RELIEF IS AVAILABLE UNDER DELAWARE LAW BECAUSE OF THE BREACH OF FIDUCIARY OBLIGATION INVOLVED IN THE FIDUCIARY'S APPROPRIATION OF THE CESTUI'S PROPERTY AT AN UNCONSCIONABLE PRICE.

The District Court, having dismissed the 10b-5 claim, held that there was no pendent jurisdiction over the state claim and, as just noted, also dismissed for lack of diversity jurisdiction. Since the amended complaint states a valid claim under Rule 10b-5, the Court has pendent jurisdiction over the state claim with respect to both Santa Fe and Morgan. The Court also has diversity jurisdiction with respect to the state claim over Santa Fe, the diverse defendants-appellees. We contend that the state claim is valid under Delaware law.

In Popkin v. Bishop, supra, 464 F2d, at 720, this Court held as follows with respect to equitable relief under Delaware law.

> "Indeed, under the applicable Delaware law, the 'entire fairness' of the merger would have to pass 'the test of careful scrutiny by the courts.' Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 110 (1952)."

That holding is directly applicable to our state claim. The amended complaint alleges a breach of fiduciary obligation in that the majority stockholder, having control and domination of Kirby, merged a dummy corporation into Kirby under the short-form statute for the purpose and with the effect of squeezing out the minority stockholders at an unconscionable price. Under "applicable Delaware law, the 'entire fairness' of the merger" would fail "the test of careful scrutiny" by the Delaware court and accordingly,

per Popkin, the Delaware law provides equitable relief. Since the defendants foreclosed the possibility of injunctive relief by consummating the merger in secret, equity will provide appropriate relief whether by way of prescribing affirmative action or awarding monetary relief.

In Lachman v. Bell, 353 F. Supp. 37 (S.D.N.Y., 1972) a diversity action was brought by a stockholder against a director for breach of fiduciary obligation under Delaware law based on a merger on unfair terms. The Court, per Gurfein, J., denied a motion to dismiss the complaint, holding as follows (42):

> "I conclude, therefore, that under Delaware law the Court would not dismiss the action but would let the cause proceed to trial even if the fairness of the merger were the cardinal issue."

Defendants' reliance below on Stauffer v. Standard Brands, 187 A2d 78, (Del. Sup. Ct.) is misplaced. The Court there reiterated "the ever-present power of equity to deal with illegality or fraud." But on the facts of that particular case, the Court held, "No illegality or overreaching is shown." There was only a small spread between the value fixed by the directors and the value claimed by the plaintiff, so the Court found that the "dispute reduces to nothing but a difference of opinion as to value." (80). There, too, there was a prior disclosure of the intention to merge (79).

In our case the defendants secretly fixed a value of $150 as against a fair value, based on the acknowledged value of marketable, physical assets, alone, of $772 - a difference of about 400 per cent. Such a gross disproportion cannot rationally be "reduce[d] to nothing but a difference of opinion." That was "overreaching" that is remediable in equity under the authorities on Delaware law cited supra. For the reasons given above (23-4) appraisal is not an adequate remedy.*

Point IV

SINCE KIRBY IS THE SURVIVING CORPORATION, A DERIVATIVE ACTION LIES IN ITS BEHALF, AS WELL AS A CLASS ACTION FOR ITS MINORITY STOCKHOLDERS. THE APPROPRIATE RELIEF SHOULD AWAIT TRIAL.

Plaintiffs are stockholders of Kirby, the surviving corporation in the merger (81A, 73A). The District Court's verbal distinction between "Old Kirby", i.e. Kirby before the merger, and "new Kirby", i.e. Kirby after the merger (79A, 82A, 95A), is misleading because, as the District Court's Opinion acknowledges (81A), "FPI [was] merged into Kirby with Kirby surviving the merger." With Kirby the surviving corporation, "Old Kirby" equals "New Kirby"; the

* Indeed, the forced taking under Delaware authority, without equitable redress for an unconscionable price, would be an unconstitutional taking without due process of law, North Georgia Finishing, Inc. v. Di-Chem, Inc., ___U.S.___, 95 S.Ct. 719, 42 L.Ed. 751 and cases cited.

nomenclature "old" and "new" has no basis in Delaware or Federal law. Since Kirby is the surviving corporation, a derivative action for its benefit lies. As the District Court noted (95A), "under Delaware, as a result of a merger, the derivative rights of the merged subsidiary pass to the surviving corporation." As Kirby is the surviving corporation, its rights remain, and a derivative suit can be brought to protect or redress them.

The District Court assumed erroneously that "a derivative recovery would be an inappropriate remedy" because either the benefits would inure "to a corporation that is no longer functioning" or to shareholders including the wrongdoers (96A). But Kirby as the surviving corporation, to whom the recovery would inure, is the functioning corporation; the corporation merged into it was only a paper corporation formed for the sole purpose of effecting the freezeout of the Kirby minority. Thus there is point to the part of the relief requested in the amended complaint; namely, "that the merger aforesaid be set aside on the grounds of the fraudulent overreaching." Here Kirby was not extinguished by the merger; accordingly, if the merger is set aside plaintiffswould continue as stockholders in Kirby.

A derivative action for the corporation surviving in the merger has already been sustained under Rule 10b-5

in Dasho v. Susquehanna Corp., 380 F2d 262 (C.A.7) and Simon v. New Haven Board & Carton Co., 250 F.Supp. 297, 298 (D. Conn.). In the latter case the Court refused to draw a distinction between mergers and other cases involving the purchase-sale of securities and held: "It is now settled that a derivative action may be brought on behalf of the Corporation under the Rule [10b-5]" (citations omitted).

Schoenbaum, supra, is also authority for maintaining this action as a derivative one. As part of the merger scheme, FPI's holding of 474,675 1/2 shares of Kirby capital stock was cancelled and Kirby issued 1,000 shares of its capital stock to Resources (Exh. A, p.27, p.2). Thus the issuance of capital stock by Kirby to Resources is itself an adequate basis to bring a derivative action on behalf of Kirby. In Schoenbaum, supra, (at 219) the Court of Appeals held:

> "The issuance by Banff of its stock to Aquitaine was a sale of securities within the meaning of section 10(b) and Rule 10b-5. The stockholders of Banff may bring a derivative action for damages to the corporation suffered by reason of a violation of section 10(b) and Rule 10b-5."

In Vine, supra, cited by the District Court in this connection (96A) the company in which plaintiff was a stockholder was extinguished in the merger.* Unlike

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* In Smallwood v. Pearl Brewing Co., 489 F2d 579 (C.A.5) the Court of Appeals held (591-2) that even in that situation, not only was a class action appropriate, but a derivative suit was also appropriate, e.g. to unwind the merger effected through a 10b-5 violation.

Vine, if the merger herein is set aside, plaintiffs' interest in Kirby, the surviving corporation, will continue and a class action may not be adequate to obtain that type of relief. Plaintiffs do not now have to elect between the remedies of a class action on behalf of the selling stockholders and a derivative action on behalf of Kirby.

Defendants contended below that, since plaintiffs are "forced sellers" and seek to maintain a class action on that basis, they cannot "simultaneously claim not to have sold it in order to maintain an action as Kirby shareholders." As we have indicated above, plaintiffs, in seeking appropriate relief, may make their election at a later date of a class action or a derivative one. Accordingly, defendants' objection is premature. In Voege, supra, 241 F.Supp. at 376, the Court held that whether the action should be derivative would be decided at a later stage, not on a motion addressed to the complaint.

Discussion of what might be the appropriate equitable remedy is plainly premature at the stage of a motion to dismiss a complaint. It is hornbook law that

> "Bad faith, fraud or other breach of trust constitutes a foundation for equitable relief" (Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 196 - involving overreaching by the majority in a corporate dissolution)

and that

> "a motion to dismiss the complaint will not search out the nature of the relief or judgment to which the plaintiff may be entitled." (Lichtyger v. Franchard Corp., 18 NY2d 528, 538.)

Equity relief may include money damages, Vine, supra, suitably allocated if appropriate to avoid benefitting the wrongdoers Pearlman v. Feldman, 219 F2d 173 (C.A.2); or monetary reformation, Ripley v. IRCA, 8 NY2d 430; or setting aside the merger where appropriate under all the circumstances. Eisenberg v. Central Zone Property Corp., 306 N.Y. 58; Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483.

Conclusion

THE JUDGMENT BELOW SHOULD BE REVERSED
WITH DIRECTION TO REINSTATE THE AMENDED COMPLAINT.

Respectfully submitted,

LEVENTRITT LEWITTES & BENDER
Attorneys for the Plaintiffs-Appellants
405 Lexington Avenue
New York, N.Y. 10017

Tel. 986-4080

Of Counsel:

AARON LEWITTES
SIDNEY BENDER

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